

# THE ECONOMIC SITUATION

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Things are slow, but we are not creeping into another recession.  
Oddly enough, it is big government and big deficits again. Or is it odd?  
It was fear of inflation that did us in. Will fear of deflation bring us out?  
South Carolina: A bumpy road ahead.  
Saving fish. Another kind of hero.

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## **Dealing with the slows one more time.**

No, we are not about enter another recession. Believe it or not, there are more workers employed nationwide than when the recently declared recession started. And yes, incomes are rising. Things aren't all that bad. But, there is hardly any job growth, and manufacturing is still almost dead in the water. With all that, it is little wonder that consumer confidence has turned south, just when unemployment numbers were heading north.

## **What's going on? Let's take a look.**

In last quarter's newsletter, I noted that the end of the war in Iraq brought renewed focus on the home economy and how poorly it was doing. Real GDP growth for 4Q2002 and 1Q2003, now finalized, had come in at 1.4% for each quarter, hardly enough growth to generate recovery in job markets. With the Iraq war officially over, the risky nature of the war—how long it might last and what the damages might be—is pretty well identified. These costs can be estimated. But delivery of this certainty brought with it a larger than predicted price for gaining and maintaining a semblance of peace. Not only that, while defense related expenditures have understandably risen, and along the way generated 70% of GDP growth for 2Q2003, so have the budgets of the nondefense agencies, especially those related to home security.

We now have deficits, large ones, for as far as the eye can see. We are back to the bad old days of big government, large increases in spending, looming deficits and growing regulation.

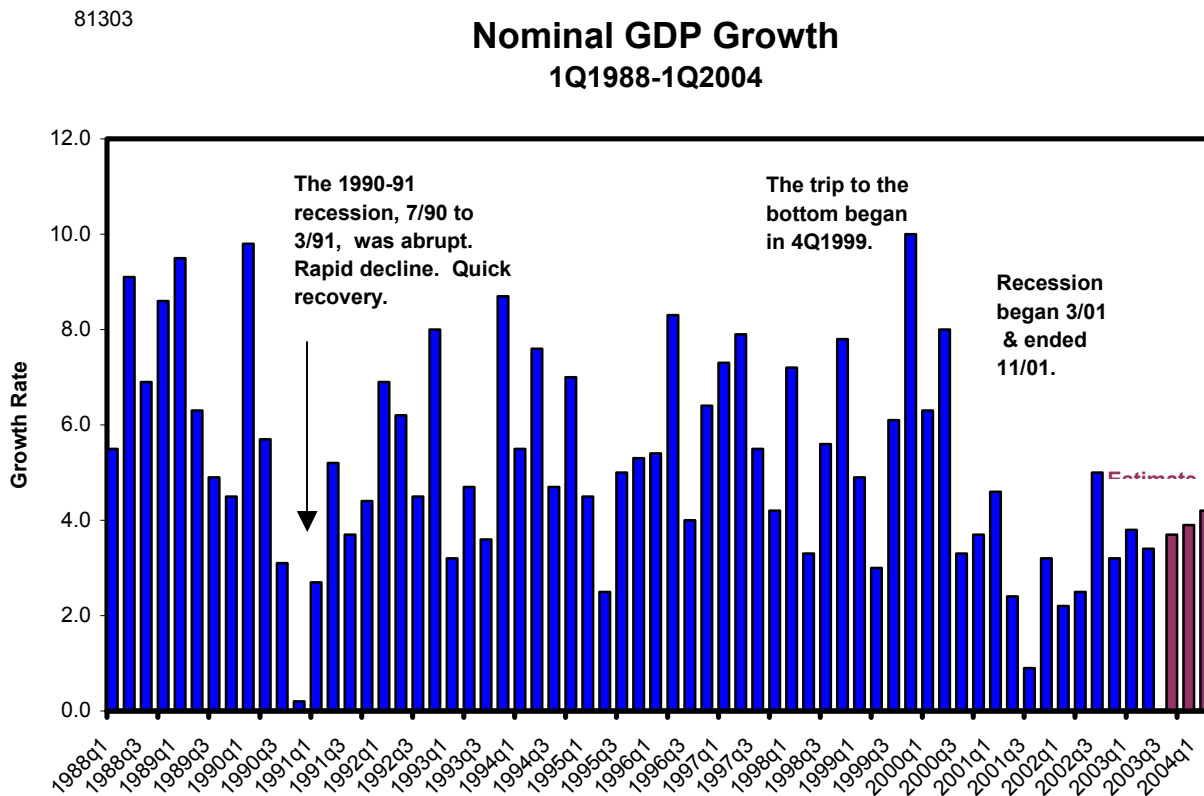
The Great American Bread Machine is being throttled again.

What a difference a day makes. And two wars.

## A quick look at GDP data tells the tale

The GDP data and estimate for the next few quarters, stated in nominal terms, are shown in the next chart. The data, which include an expected inflation rate of around 1.5% are smoother than what will likely happen and are based on the recent forecasts of the Federal Reserve Board, the Congressional Budget Office, and Merrill Lynch. While there is not perfect agreement across these sources, there is a common element of optimism about the future.

For now, at least, there are few voices suggesting that we will be haunted by a ghost of the recent recession.



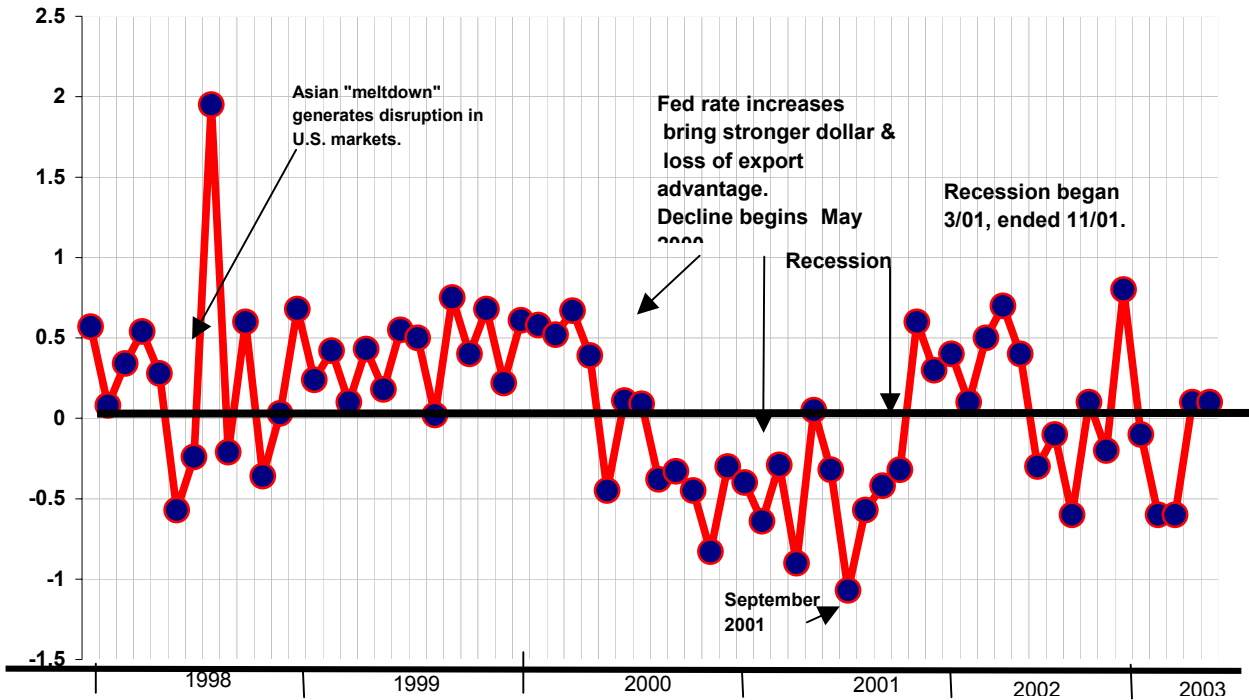
## The manufacturing economy continues to lag.

The nation may not be suffering a recession, but manufacturing is. The goods producing sector continues to be the vulnerable part of the national economy. In the last few months, the declining value of the dollar, due mostly to rock-bottom U.S. interest rates, and the continued recovery of the national economy have combined to quicken the pulse of the factory system. As yet, due partly to huge increases in productivity, there are no meaningful employment effects.

The result of a positive growth trend can be seen in the next chart that plots industrial production. The good news is seen in the last two months. Finally, there are two consecutive months of above-zero growth.

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### Growth in U.S. Industrial Production: 1998-2003



### Should we get prepared for harmful deflation? I don't think so.

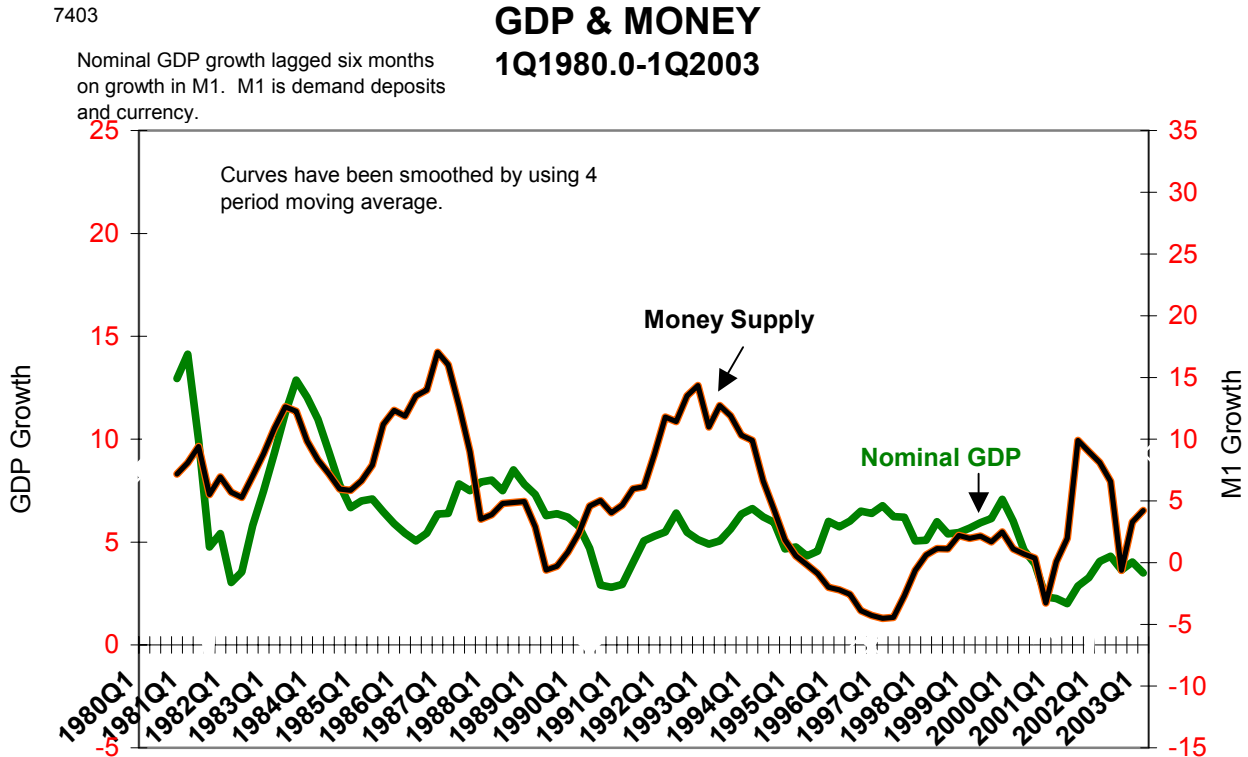
From time to time, Alan Greenspan waves deflation's ugly sheet in the air and then indicates that fearless leadership at the Fed will protect the nation from the horrors of falling prices. Lower interest rates and expanding credit form the solution. This too is a reversal. It wasn't that long ago that we were being told that pending inflation was public enemy number one. Just two years ago, higher interest rates and tight money were what the doctor ordered. (The manufacturing recession that resulted from tight money early 2000 solves that problem.)

But just in case you are wondering about deflation and what might happen to the economy, consider this information provided by none other than the Federal Reserve Bank. There have been several periods of deflation in the United States since the Civil War. There were periods when the common inflation measures registered negative numbers. In every case, real GDP continued to rise. Indeed, in three of four historic periods, GDP growth averaged 4.02%, and that ain't hay.

Looking back is one thing. What about action? What has the Fed been doing about money growth? And how does this relate to GDP growth?

The next chart shows a relationship between growth in M-1, the total of demand deposits and circulating currency and the simplest of all measures of the money supply, and growth in nominal GDP six months later. The chart gives some assurance that money matters. When the Fed opens the valves, the economy responds. The data also indicate that the money valve has been open in recent months. This gives some assurance that nominal GDP will be rising in the quarters ahead.

This also implies that we can expect a bit more inflation.



### And what about South Carolina?

The Palmetto economy was beginning to hum a bit in the first few months of this year. But then, something happened. Employment growth sagged in May and June. Retail sales and income growth sagged also. South Carolina's economy was hit by the lagging durable goods activity. Once again, the state's heavy manufacturing economy gets a magnified dose of the national slows.

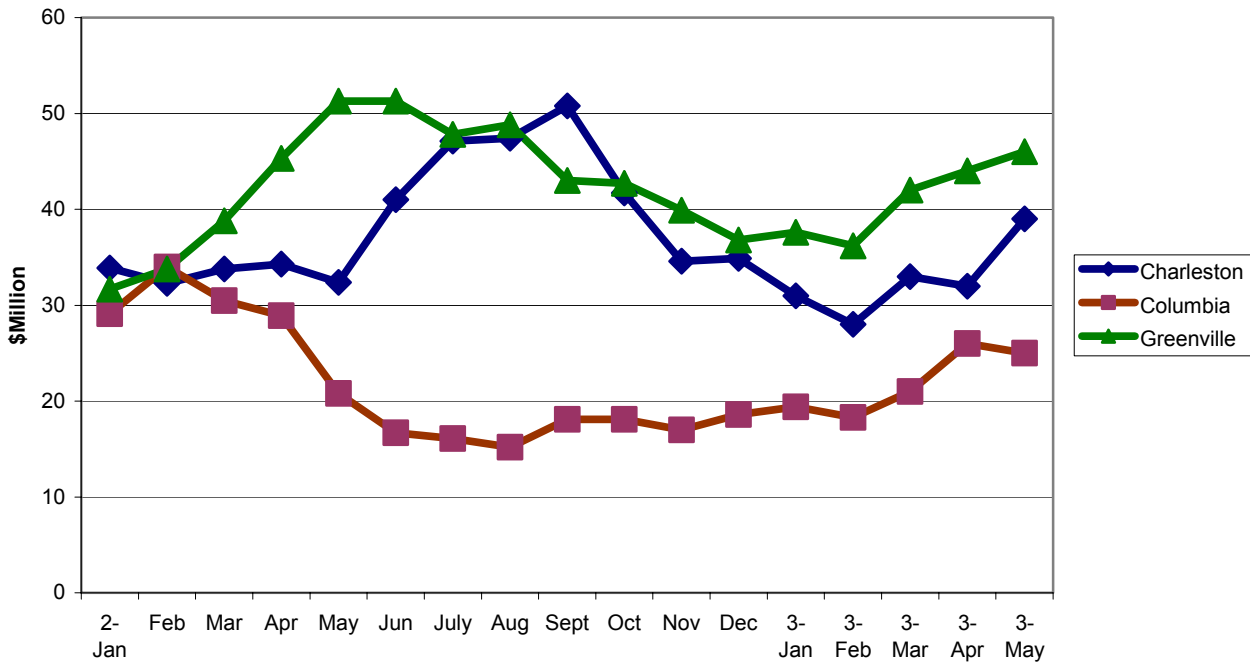
The effects of the slowing S.C. economy, and a bit of recovery as well, can be seen in the next chart on the value of housing starts in the three major metro areas.

The sagging and now recovering Greenville housing market can be compared with Charleston's market. They follow similar patterns with minor differences in timing. Columbia's market, on the other hand, marches to the public sector drum beat, and those drums have been pretty quiet lately.

Thus far, construction and services have nudged the state forward. Manufacturing is beginning to look better, but it will be a while before the manufacturing recession ends.

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**Housing Starts: Charleston, Columbia, Greenville SMSAs  
January 2002-May 2003**



**Still looking for heroes.**

In the mid-1940s, an English angler and a lawyer, John Eastwood, looked closely at the 16 acts of Parliament that presumed to protect water quality in rivers, lakes, and streams and decided that none of them were any good. At the time, rivers were classified by use; there was little effort to reduce pollution in streams classified as receivers of industrial waste. Fish, the aquatic environment, and the joy of fishing all suffered.

Eastwood understood common law. He knew that owners and occupiers of land along streams held environmental rights not be harmed without approval. He reasoned that if he could get landowners to join an association of anglers, he and the association would use the resulting dues to bring common law suits against polluters who harmed the property rights of the landowners.

Eastwood sat down at the kitchen table and wrote 3,000 letters, by hand, to drum up support for his idea. About a year later, he formed the Anglers' Cooperative Association, today known as the Anglers' Conservation Association. He appealed to the self interest of anglers, and in doing so led a movement that has resulted in cleaner waters throughout England.

Since being formed, the ACA, as it is known, has brought over 2,000 cases against polluters. They have lost three. The catalog of cases involve actions against city governments, electrical

utilities, chemical plants, and even trout farms. When they sue, the ACA does not ask for fines. They do not fish for money. They ask for injunctions. Stop the pollution. The ACA sponsors the formation of regional angling societies and has extended its programs to include ocean property.

John Eastwood is a hero of sorts. He has done well by doing good. Instead of organizing and lobbying for more legislation, Eastwood took action based on the protection of property rights.

One person can accomplish a lot.